Who Really Cooks the Books?

By Warren E. Buffett

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There is a crisis of confidence today about corporate earnings reports and the credibility of chief executives. And it's justified.

For many years, I've had little confidence in the earnings numbers reported by most corporations. I'm not talking about Enron and WorldCom -- examples of outright crookedness. Rather, I am referring to the legal, but improper, accounting methods used by chief executives to inflate reported earnings.

The most flagrant deceptions have occurred in stock-option accounting and in assumptions about pension-fund returns. The aggregate misrepresentation in these two areas dwarfs the lies of Enron and WorldCom.

In calculating the pension costs that directly affect their earnings, companies in the Standard & Poor's index of 500 stocks are today using assumptions about investment return rates that go as high as 11 percent. The rate chosen is important: in many cases, an upward change of a single percentage point will increase the annual earnings a company reports by more than $100 million. It's no surprise, therefore, that many chief executives opt for assumptions that are wildly optimistic, even as their pension assets perform miserably. These C.E.O.'s simply ignore this unpleasant reality and their obliging actuaries and auditors bless whatever rate the company selects. How convenient: Client A, using a 6.5 percent rate, receives a clean audit opinion -- and so does client B, which opts for an 11 percent rate.

All that is bad, but the far greater sin has been option accounting. Options are a huge cost for many corporations and a huge benefit to executives. No wonder, then, that they have fought ferociously to avoid making a charge against their earnings. Without blushing, almost all C.E.O.'s have told their shareholders that options are cost-free.

For these C.E.O.'s I have a proposition: Berkshire Hathaway will sell you insurance, carpeting or any of our other products in exchange for options identical to those you grant yourselves. It'll all be cash-free. But do you really think your corporation will not have incurred a cost when you hand over the options in exchange for the carpeting? Or do you really think that placing a value on the option is just too difficult to do, one of your other excuses for not expensing them? If these are the opinions you honestly hold, call me collect. We can do business.

Chief executives frequently claim that options have no cost because their issuance is cashless. But when they do so, they ignore the fact that many C.E.O.'s regularly include pension income in their earnings, though this item doesn't deliver a dime to their companies. They also ignore another reality: When corporations grant restricted stock to their executives these grants are routinely, and properly, expensed, even though no cash changes hands.

When a company gives something of value to its employees in return for their services, it is clearly a compensation expense. And if expenses don't belong in the earnings statement, where in the world do they belong?

To clean up their act on these fronts, C.E.O.'s don't need ''independent'' directors, oversight committees or auditors absolutely free of conflicts of interest. They simply need to do what's right. As Alan Greenspan forcefully declared last week, the attitudes and actions of C.E.O.'s are what determine corporate conduct.

Indeed, actions by Congress and the Securities and Exchange Commission have the potential of creating a smoke screen that will prevent real accounting reform. The Senate itself is the major reason corporations have been able to duck option expensing. On May 3, 1994, the Senate, led by Senator Joseph Lieberman, pushed the Financial Accounting Standards Board and Arthur Levitt, then chairman of the S.E.C., into backing down from mandating that options be expensed. Mr. Levitt has said that he regrets this retreat more than any other move he made during his tenure as chairman. Unfortunately, current S.E.C. leadership seems uninterested in correcting this matter.

I don't believe in Congress setting accounting rules. But the Senate opened the floodgates in 1994 to an anything-goes reporting system, and it should close them now. Rather than holding hearings and fulminating, why doesn't the Senate just free the standards board by rescinding its 1994 action?

C.E.O.'s want to be respected and believed. They will be -- and should be -- only when they deserve to be. They should quit talking about some bad apples and reflect instead on their own behavior.

Recently, a few C.E.O.'s have stepped forward to adopt honest accounting. But most continue to spend their shareholders' money, directly or through trade associations, to lobby against real reform. They talk principle, but, for most, their motive is pocketbook.

For their shareholders' interest, and for the country's, C.E.O.'s should tell their accounting departments today to quit recording illusory pension-fund income and start recording all compensation costs. They don't need studies or new rules to do that. They just need to act.

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